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RETIRE EARLY with REAL ESTATE

how SMART INVESTING can help you ESCAPE THE 9-TO-5 GRIND and DO WHAT MATTERS MORE

CHAD CARSON

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PART 1

WHY REAL ESTATE INVESTING?

Real Estate Investing Is an I.D.E.A.L. Vehicle for Early Retirement

CHAPTER 1
WHY REAL ESTATE IS THE I.D.E.A.L. INVESTMENT

People are always blaming their circumstances for what they are. I don't believe in circumstances. The people who get on in this world are the people who get up and look for the circumstances they want, and, if they can't find them, make them.

—GEORGE BERNARD SHAW

As you probably know, climbing the financial mountain isn't unique to real estate investing. Just like there are multiple paths up a mountain, there are other vehicles to get there that have been used by successful early retirees. For example, you could use dividend stocks, bonds, small businesses, index funds, bank CDs, and more to climb to your goals.

But of all these choices, real estate investing is my favorite. And my guess is you like it too since you've picked up this book! Real estate investing is a perfectly suited vehicle for aspiring early retirees. It gives you an incredible amount of control over the method and the timing of your exit from the rat race. Let me explain why by showing how real estate investing is I.D.E.A.L.

I learned this acronym in the first real estate book I read after college. And I have yet to find a better way to explain the core benefits of real estate investing. I.D.E.A.L. tells you the primary ways you can profit with investment properties:

- Income
- Depreciation
- Equity
- Appreciation
- Leverage

I'll explain each one in more detail.

Income

Income is the core benefit of real estate investing. Even the worst rentals I have produce more income than equivalent amounts of money in other assets like stocks or bonds. For example, on March 2, 2018, the dividend rate of the S&P 500 (a group of major stocks) was 1.82 percent.[1] And the interest yield of a ten-year United States Treasury bond (the lowest-risk type of bond and is essentially a loan to the government) on the same date was 2.86 percent.[2]

But in the right markets, I often see unleveraged (no debt) income returns of 5 to 10 percent with rental properties, even after paying all expenses, including a property manager. And with safe, long-term leverage (if you choose to do that) you can sometimes see those income returns double to 10 to 20 percent or more.

To put that into perspective, here's a chart comparing actual yearly income (pretax) for an S&P 500 index fund, a ten-year U.S. Treasury bond, and an unleveraged rental property with a 7 percent income yield.

ASSET TYPE	INCOME YIELD	INCOME/YEAR FOR $100,000 INVESTMENT
S&P 500 Index Fund	1.82%	$1,820
10-Year U.S. Treasury Bond	2.86%	$2,860
Unleveraged Rental Property	7%	$7,000

1 "S&P 500 Dividend Yield Statistics." Last modified March 2, 2018. www.multpl.com/s-p-500-dividend-yield/.

2 "10-Year U.S. Treasury Bond Statistics." Last modified March 2, 2018. www.multpl.com/10-year-treasury-rate.

That's an *enormous* difference! A $1 million portfolio invested 100% in real estate at those numbers would receive $70,000 per year before tax. While the same amount in stocks would produce $18,200, and in U.S. Treasury bonds would produce $28,600. As an early retiree living off of your assets, which would you prefer? More income or less?

And the income from an unleveraged portfolio of quality rentals is very flexible. Prices and rents of quality real estate tend to keep up with inflation. And unleveraged properties, as in this example, can possibly survive deflationary environments if rents go down. But most of all, consistent, steady income from rentals is the Holy Grail for early retirees. That income allows you to live, explore, and do what matters.

Depreciation

Do you ever get excited about the U.S. Tax Code? Well, me either ... until now! As of this writing, the U.S. government requires real estate investors to spread out most of the cost of real estate purchases over 27.5 years (for residential property).[3] This creates what's called a depreciation expense, which can shelter or protect your income from taxes and reduce your tax bill.

Why does this happen? Unlike other business expenses, depreciation doesn't actually come out of your bank account. It's a paper loss. But this paper expense can still offset taxable income and save money on your tax bill. Here is a basic example.

Scenario #1 (without depreciation expense):
$10,000 taxable rental income x 25% federal income tax rate = $2,500 taxes owed

Scenario #2 (with depreciation expense):
$10,000 rental income – $3,000 depreciation expense = $7,000 taxable rental income
$7,000 x 25% federal income tax rate = $1,750 taxes owed

Tax Savings = $2,500 – $1,750 = $750

The higher your tax rate, the more taxes you would save in this example. Depreciation is not unique to real estate, but real estate investing uniquely

3 "Publication 946 (2016), How to Depreciate Property." Last updated September 11, 2017. www.irs.gov/publications/p946#en_US_2013_publink1000107524.

benefits from depreciation. Why? Because the cost of real estate is so large and often purchased with debt. A $250,000 building depreciated over 27.5 years provides a tax shelter of $9,091 per year. If you had three rental properties at that cost, you'd shelter $27,273 of income from taxes and *possibly* save $6,818 on your tax bill (at a 25 percent rate).

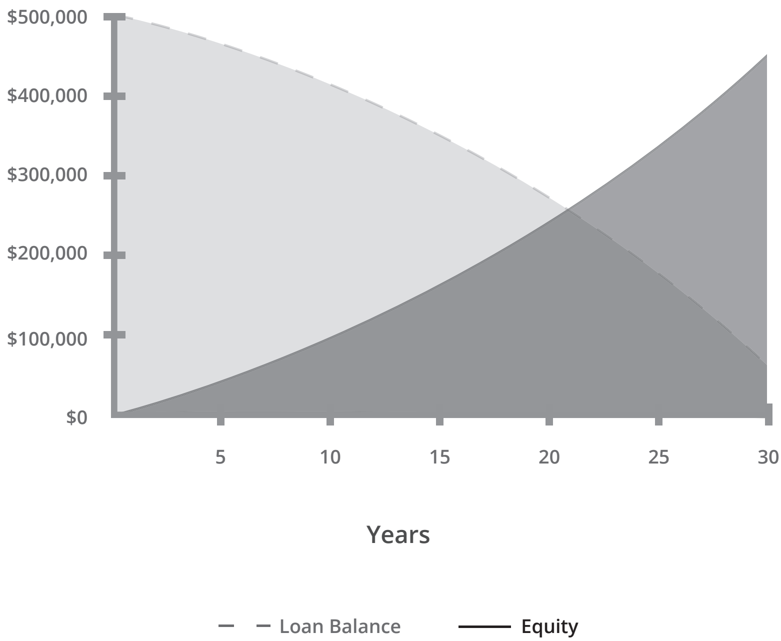
I say "possibly," because this is a nuanced part of the tax code. There are several layers of rules that affect real estate tax deductions. That's beyond the scope of this book, so for now I'll just say that a CPA (certified public accountant) who specializes in real estate investing is a must-have on your personal real estate team.

And keep in mind that what the IRS giveth, the IRS taketh away. When you sell a rental property, it's very likely that you'll have to recapture the depreciation and pay taxes on it. The tax rate on this recaptured real estate depreciation is typically 25 percent (as of 2018). This creates a big incentive to keep real estate or to use other tax-savings strategies when selling, like a 1031 exchange. I'll discuss the 1031 exchange later in Chapter 17, "The Trade-Up Plan."

Equity

This benefit is one of my *favorite* parts of real estate investing. If you borrow money to purchase your investment property and have at least break-even cash flow, your tenant essentially pays off your property for you. Explained another way, one part of a typical mortgage payment is principal paydown on your mortgage. So, if you have enough rental income to pay your expenses and your mortgage, the tenant is working hard to increase *your* equity in the property.

Equity Buildup & Loan Paydown Over Time



I don't know about you, but I love the idea of other people working hard to build my net worth! And the tenants also get great value in return. They get to live in a nice, clean, well-cared-for rental property, and they get to deal with a fair property owner. It's a clear win-win.

Appreciation

Over many years, real estate tends to appreciate (increase in price) at the same rate as inflation (1–2 percent per year) on average.[4] Of course, real es-

4 www.inflation.eu/inflation-rates/united-states/historic-inflation/cpi-inflation-united-states.aspx.

tate is very local, so the actual rate can vary widely from place to place. But when any kind of appreciation is combined with the other benefits already discussed, the total return can be very attractive.

For example, if your unleveraged property produced 7 percent income returns and 3 percent appreciation, your long-term return could average around 10 percent (ignoring tax costs or benefits for the moment). But this passive type of appreciation does not tell the whole story. The *real* power of appreciation in real estate is the type of price increase you can control.

First, appreciation can often be built into a purchase of real estate from the beginning. If you are out looking for properties all the time, you will be able to find bargains purchased below full value. For example, if you buy a property normally worth $200,000 at a 10 percent discount, you've built in appreciation of $20,000 from day one.

Second, there is a concept called forced appreciation. This means that you do something to the property in order to increase its value. This is where the entrepreneur in you can shine and also make a lot of money. For example, let's say you buy an old property in an otherwise attractive neighborhood. The property needs cosmetic upgrades inside and outside the house. You invest $30,000 into carefully chosen upgrades, such as better landscaping, paint, new flooring, a new kitchen, and new bathrooms. The $30,000 investment in repairs may increase the value of the house by $70,000 (this, of course, depends upon the particular situation). The $40,000 difference is the forced appreciation.

Repairs are a typical way to force appreciation, but savvy investors also look for other opportunities. You may be able to increase density (like adding an extra rental unit), improve rental rates, decrease expenses, improve zoning, and more. All of these could potentially force the appreciation of a property.

Leverage

I already mentioned the use of debt (that is, leverage) when discussing equity buildup. But leverage in general can magnify all the other benefits mentioned here. For example, without leverage your $100,000 in savings could only buy one property worth $100,000. But with leverage, using an 80 percent mortgage (say, making a 20 percent down payment), you could instead buy five properties worth $100,000 with $20,000 down on each. All of the income, depreciation, equity, and appreciation benefits above would be magnified because of the leverage.

But keep in mind, leverage works both ways. Just like *benefits* are magnified with leverage, *losses* can also be magnified. I have personally seen more promising real estate investors go out of business because they couldn't make their debt payment than for any other reason. So a smart investor very carefully uses debt, if he or she uses it at all.

You've now learned the core benefits of real estate investing, but in the next chapter, let's look at four more reasons that aspiring early retirees should invest in real estate.

PROFILE OF A REAL ESTATE EARLY RETIREE

KAT HORN

Cashflow Kat (cashflowkat.com)

Location: Fredericksburg, Virginia

Chad's Favorite Quote from Kat:

"Steel your resolve and just go for it! You can get stuck in a loop of never-ending learning and searching."

WEALTH-BUILDING STATISTICS

- **Profession/Career:** Lawyer, broker, but primarily a stay-at-home mom
- **Income During Wealth-Building Phase:** $150,000 to $199,999/year
- **How Big a Role Did Real Estate Play in Wealth-Building?** Primary vehicle
- **Primary Real Estate Strategy(ies):** Long-term rentals, live-in flip

FINANCIAL INDEPENDENCE STATISTICS

- **Age at Financial Independence:** 41 to 45
- **Annual Expenses in Retirement:** Between $75,000 to $100,000
- **Ideal Number of Rentals in Retirement:** 6 to 10
- **Primary Source of Retirement Income:** Rental income
- **Secondary Source of Retirement Income:** Periodic sale of stocks, Social Security income, pension
- **Ideal Debt Level of Real Estate Portfolio:** Between 26% to 50% loan to value

Q&A

Q: Can you explain in more detail how you built your current wealth?
Although I've done two live-in flips, I have primarily focused on long-term buy and holds. I lived in many of the buy and holds prior to converting them to rental properties. Initially my husband and I purchased a home that needed work, and we ended up selling it quickly for a good profit when he was transferred unexpectedly. The flip was unintentional but advantageous. So we used that profit to buy another home that needed work. After remodeling it and living in it for several years, we made the deliberate decision to move out and convert it to a rental property. Once we did that successfully, it was hard to stop! We kept buying homes, living in them, fixing them up, and then turning them into rentals. In addition, however, we purchased two duplexes that we never resided in, because, after a few repairs, they both flowed cash immediately.

Q: What were the biggest obstacles and setbacks during your wealth-building stage? How did you overcome or push through them?
I think the biggest obstacle is always finding the money to do the next deal. Even though *you* know you can meet all of your mortgage obligations with your rents, lenders can be tough with their set debt-to-income requirements. So instead of getting too creative with hard-money loans or partnerships, I just kept building my real estate portfolio slowly. Every couple of years I was able to move forward and make another acquisition through traditional mortgage lending (especially since many of my properties were initially my primary residence). It was great to lock in long-term low-cost financing, and then watch over the years as my rents would continue to climb and my cash flow would continue to grow. That's the beauty of the long-term buy and hold, the numbers just keep getting better.

Q: What's your No. 1 best tip for those looking to build wealth with real estate investing?
Steel your resolve and just go for it! You can get stuck in a loop of never-ending learning and searching while being too intimidated to

just pull the trigger and make a rental property purchase. You have to push through the fear and take a chance. Just remember that you are not alone with your feelings, as most of us started in the same boat with the same fears and uncertainties. Taking action and getting started is the key.

Q: Can you explain in more detail your post–financial independence income? How do you plan on living off of this income?
My husband and I will have more rental income from our long-term buy and hold properties than from any other source in retirement. Happily, this rental income will be enhanced by his government pension (which will be equivalent to about 40 percent of his current salary). Then, for later years, we will be looking to 401(k) and IRA funds. Finally, there is Social Security … but I can't say I'm counting on it! I'm concerned that by the time I am eligible to draw Social Security, it will be means-tested and I'll no longer have that as an income source. In fact, the lack of stability in Social Security is one huge reason to develop other income streams, like rental real estate.

Q: What concerns do you have for the future related to retirement income? How will you address that?
Honestly, I feel so secure because of my rental property income. Rising rents are a wonderful hedge against inflation. And in my own experience, even during the 2008 Great Recession, I didn't have to lower any of my rents. Also, my properties are located in several different markets that have all seen growth in populations and in their economies. Consequently, I feel as though I've put myself in a great position to weather future storms. As much as I like to gripe about landlord duties some days, I feel tremendously blessed that I began my real estate investing journey in my early thirties.

Q: Do you plan to start selling your real estate holdings? If so, when and how?
I will sell the residential properties once I no longer want to be bothered with the hands-on property management. Instead of hiring managers, I foresee selling most or all of the residential properties and

doing a 1031 exchange into something like a commercial triple-net lease property (or properties). I want to reap the tax advantages of a 1031 exchange and have a stable of properties that require little to no management. I also foresee placing them in a trust so that they will someday be assets for my children.

Q: What's your No. 1 best tip for those looking to live off of investment income after retirement/financial independence?

My tip is to structure your real estate investing to include at least some long-term buy and hold properties. Those are the properties that will provide the income stream and require less effort (hopefully!) as you retire and want to focus on other pursuits. I used to talk to my husband about doing short-term flips in retirement, but it's hard work. And I realized that I don't want to work that hard in retirement.